Creating Money: for what purpose?

Towards a Sustainable Financial System

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Theory: Money creation and debt
Empirics: Rising leverage and the policy conundrum
Categories of credit
Implications
Banks create credit, money and purchasing power

Loan to entrepreneur 100

Bank

100

Credit to entrepreneurs deposit account
Two (closely related) issues

- Bank credit, money and purchasing power creation
- Debt contracts – whether bank or non-bank
Credit creation as enabler of adequate demand growth

Pure metallic money

- Money supply constrained by precious metal resources
- Real growth may require downward flexibility of wages and prices
- Pure ‘hoarding’ possible

Alternatives / complement

- Pure fiat money creation: unfunded fiscal deficits
- Private bank (or other) credit extension
- Funded fiscal deficits
Alternative ways to stimulate nominal demand

Pure fiat money: unfunded fiscal deficits
- New money
- Increase in private NFA

Private credit and money creation
- New money
  - And future private debt
- No increase in private NFA
  - But maturity transformation

Funded fiscal deficits
- No New money
- But increase in private NFA
- And future public debt liability
Fiat money creation

- Always possible
- Public authorities can choose optimal quantity

Private credit creation

- Allocation determined by market disciplines
  - Is the amount created optimal?
  - Implications of resulting debt contracts?

Advantages

Disadvantages

- Allocation is political decision
- Tendency to excessive use
Banks create credit, money and purchasing power

Wicksell’s thesis:

- Bank purchasing power creation optimal if:

\[
\text{Money Rate of Interest} = \text{Natural Rate of Interest (MPC)}
\]
Credit to businesses/entrepreneurs/other investors in real capital

Skews demand toward investment, not consumption

“Forced saving”

“An increase in capital creation at the cost of consumption, through the granting of additional credit without voluntary action on the part of the individuals who forego consumption, and without them deriving any immediate benefit”.

(Friedrich Hayek, The Monetary Theory of the Trade Cycle, 1929)
Credit driven “forced saving”

**Potential Benefit**
- More rapid rate of growth
- Japan/Korea “financial repression” models of development

**Potential Disadvantage**
- Over-investment cycles
- Macro-economic imbalance
  - Growth sustained by yet more credit
Two (closely related) issues

- Bank credit, money and purchasing power creation
- Debt contracts – whether bank or non-bank
Debt contracts: The finance theory perspective

- Non-state contingent contracts overcome “costly state verification” advantages over equity contracts in business finance

- Essential to mobilisation of capital

- Empirical evidence of benefits of financial deepening, i.e. bank credit ÷ GDP
The pre-crisis orthodoxy

Central Banks / monetary theory

Low and stable inflation objective

Financial system a veil –

“money, credit and banking play no meaningful role”

Implicitly Wicksellian

Finance theory

Debt contracts essential

General confidence that free markets will produce optimal balance

Main concerns about insufficiently high credit ÷ GDP ratios
The problems with debt

- Cycles of over-supply and over-demand
- ‘Local thinking’

- Bankruptcy and default
- Rollover need and impaired lending capacity
- Debt overhang
Theory: Money creation and debt

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Categories of credit

Implications
Dynamics of real GDP and credit
(Year on year % change)

Private domestic credit as a % of GDP: 1950 – 2011

China: total social finance to GDP
The Dilemma

Pre-crisis path of nominal GDP growth  \( \sim 4\% - 5\% \)

Pre-crisis path of credit growth  \( \sim 10\% - 15\% \)

\( \sim 2\% \) real growth

\( \sim 2\% \) inflation

If central banks had raised interest rates to slow credit growth
.... this would presumably mean slower nominal GDP growth?

We seem to need \( \dot{C} > \text{NGDP} \) to ensure adequate NGDP
.... but this produces financial instability and post-crisis recession
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Categories of credit

Implications
Three conceptually distinct functions of lending

Finance of increased consumption

- Enabling inter-temporal shift of consumption within lifetime income

Finance of new capital investment

- Non-real estate
- Commercial real estate
- Residential real estate
- Human capital

Finance of purchase of existing assets

- Real estate
- Collectibles
- Existing business assets – e.g. Leveraged Buy Outs
Categories of debt: UK, 2009

- **Other corporate**
  - Primarily productive investment
  - £232

- **Commercial real estate**
  - Some productive investment and some leveraged asset play
  - £243

- **Residential mortgage (including securitizations and loan transfers)**
  - Mainly purchase of existing assets
  - But also achieves life-cycle consumption smoothing
  - £1235

- **Unsecured personal**
  - Pure life-cycle consumption smoothing
  - £227
Credit and asset price cycles

- Expectation of future asset price increases
- Increased credit extended
- Increased asset prices
- Increased borrower demand for credit
- Increased lender supply of credit

- Low credit losses: high bank profits
  - Confidence reinforced
  - Increased capital base

- Favourable assessments of credit risk
Credit extension and house prices

House prices 2000 – 2007

Household debt as a % of GDP 2000 – 2007

Source: Ministry of Housing (Spain), S&P (US), DCLG

Source: BEA; ONS; ECB
Inequality, demand and credit

- Rich have higher marginal propensity to save than poor
- Rising inequality
- Deflationary impetus – growth of NGDP falls
- Savings not matched by investment
- Deflationary impetus offset:
  - NGDP growth maintained
  - Growth in credit intensity
- Rich lend to poor
- Central bank facilitates

Institute For New Economic Thinking
Global current account balances as a % of world GDP

Source: IMF BOPS
The problems with debt

- Cycles of over-supply and over-demand
- ‘Local thinking’

- Bankruptcy and default
- Rollover need and impaired lending capacity
- Debt overhang
Japanese government and corporate debt: 1990 – 2010

Source: BoJ Flow of Funds Accounts, IMF WEO database (April 2011), FSA calculations
Shifting leverage: Private and public debt-to-GDP

Source: OECD National Accounts
Fiat money creation

- Always possible
- Public authorities can choose optimal quantity

Private credit creation

- Allocation determined by market disciplines
- Optimal amount ensured by policy interest rate?

Advantages

- Allocation is political decision
- Tendency to excessive use

Disadvantages

- Market misallocation possible
  - Overinvestment cycles
  - Existing asset price cycles
- No, because of heterogeneity of interest rate elasticity
- Ongoing debt contracts rollover and overhang effects
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Categories of credit

Implications
Policies required to achieve more stable growth

Reduction in inequality or at least reduced pace of increase in inequality

Reduction in global current imbalances between surplus and deficit nations
  - Remove biases to credit creation in deficit countries
  - Remove biases to excessive savings in surplus countries

Integrated set of monetary, macro-prudential and fiscal policies to lean against ‘too much of the wrong sort of debt’.
Specific policy options and issues

Constrain level as well as rate of growth of leverage

Increase capital risk weights for real estate finance above IRB estimates

LTV and LTI limits in real estate lending

Banks with dedicated focus on non-real estate business finance

But no precise threshold for ‘Too Much’ leverage

Social optimal weights ≠ privately optimal
Address externality and bias

Borrower constraint since lender constraints imperfect

To avoid “crowding out”